PETITION FOR A WRIT OF CERTIORARI

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SUPREME COURT OF THE UNITED STATES

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OCTOBER TERM, 1952

No. 332

CENTRAL CUBA SUGAR COMPANY,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS, SECOND CIRCUIT.

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PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS, SECOND CIRCUIT.

To the Honorable, the Chief Justice and Associate Justices of the Supreme Court of the United States:

The undersigned, on behalf of the above-named petitioner, prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Second Circuit affirming in part and reversing in part a decision of The Tax Court of the United States, as to appeal of Central Cuba Sugar Company, petitioner herein; and reversing a decision of The Tax Court of the United States, as to appeal of Commissioner of Internal Revenue, respondent herein.

Opinions Below

The findings of fact and opinion promulgated by The Tax Court of the United States herein are reported at pages

40 to 60 of the Transcript of Record. The Order and Decision of The Tax Court is reported at page 61 of Volume I of the Transcript of Record and was entered May 28, 1951. The opinion of the Court of Appeals for the Second Circuit is reported in Supplement to Transcript of Record at pages 8 to 15 of Volume II; and Judgment of the Court of Appeals of July 7th, 1952 is reported at page 15 of Supplement to Transcript of Record of Volume II.

Jurisdiction

Findings of fact and opinion of The Tax Court of the United States were promulgated April 24, 1951 (Tr. pp. 40 to 60, Volume I). The Order and Decision of The Tax Court was entered May 28, 1951 (Tr. p. 61, Volume I). Petitions to review decision of The Tax Court by United States Court of Appeals for the Second Circuit, pursuant to Title 26 U. S. C. A., Sections 1141 and 1142, were filed August 14, 1951 by taxpayer (Tr. p. 534, Volume I), and August 28, 1951 by Commissioner, (Supplement to Transcript of Record, pp. 1-3, Volume II). The Jurisdiction of this Honorable Court is invoked under the provisions of Section 347(a), Title 28 U. S. C. A., and Sections 1141 and 1142, Title 26 U. S. C. A.

Questions Presented

1. The right of petitioner to deduct interest accrued at contract rates, for the use or forbearance of borrowed money, for the taxable years in question, within the meaning of Sections 23(b) and 43 of the Internal Revenue Code; and

2. The carry-back of net operating loss for the period July 1st to November 14th, 1942 within the meaning of Section 23(s) of the Internal Revenue Code.

Statutes Involved

The statutes involved and pertinent parts of the Moratorium Laws of Cuba (with respect to the first question) are attached as an appendix to the petition.

Regulations

The pertinent regulations under statutes involved are also copied in the appendix to the petition.

Statement of Case

The petitioner is a corporation incorporated under the laws of the State of New York on May 19, 1911. It commenced business in the Republic of Cuba on or about July 1, 1911. It adopted a fiscal accounting period ending June 30. It continued to transact all its business in Cuba under a registration of its charter with the Mercantile Registry, as required by the laws of Cuba, until November 14, 1942. Petitioner transferred its properties to the Central Cuba Sugar Company of Cuba on November 14, 1942, under a plan of reorganization within section 112(g) of the Internal Revenue Code (Tr. p. 42).

The property owned by petitioner during the taxable years in question consisted of land, buildings, personal property and sugar mills in Cuba. The land owned was used for the cultivation of sugar cane and the cane grown was manufactured into raw sugar in its sugar mill properties. Petitioner transacted no business of a commercial character except in Cuba. The stockholders of petitioner were at all times citizens and residents of Cuba with the exception of a minor stock interest. All of the gross income of petitioner has at all times been derived from sources outside the United States. Because of the fact that the charter of petitioner was issued by the State of New York and the fact that it maintained a statutory office at 149 Broadway,

New York petitioner has regularly filed corporate income tax returns in the second collection district of New York (Tr. pp. 42 and 43).

During the fiscal years of petitioner ending June 30, 1940 to and including the date of Novemrber 14, 1942 (in the fiscal year ended June 30, 1943), the petitioner owed debts which arose from money it borrowed for use in its business. These debts were of two classes: (1) the balance of $3,815,-334.24 evidenced by first mortgage refundable bonds of the original amount of $5,000,000, bearing *interest at five per cent per annum,* and (2) the amount of $4,886,295.19 being money loaned by J. M. Tarafa during his lifetime prior to July, 1932, bearing *interest at three per cent per annum.* Tarafa, during his lifetime, was the principal stockholder of petitioner and up to the time of his death in July, 1932 he owned as community property under the laws of Cuba the bonds evidencing the mortgage indebtedness of petitioner in the amount above set forth. At the time of the settlement of Tarafa's estate on July 30, 1937, the indebtedness owed to him by petitioner was transferred and assigned by the executor of his will and his surviving wife to Securities and Real Estate Company, a Cuban corporation. Prior to July 30, 1937, the stock of that corporation was owned as community property by Tarafa and his wife. During the years involved and since the death of Tarafa's wife in 1941 the stock of Securities and Real Estate Company has been owned by their children and heirs at law. Since the deaths of Tarafa and his wife the stock of petitioner and Central Cuba Sugar Company of Cuba, with the exception of a minor interest, has been owned by their children and heirs in law, who are all citizens and residents of Cuba (Tr. pp. 43 and 44).

In August, 1934 Cuba, acting in the exercise of its sovereign powers, declared and decreed a moratorium on debts and monetary obligations incurred and owing by its citizens

and residents. By that moratorium the maturity date of all debts was fixed at June 30, 1970, and the rate of interest that could be demanded by creditors was fixed at one per cent of the principal of debts in excess of $800,000. The moratorium, however, was limited to debts prior to August, 1934 and it was permissible under the moratorium decree laws that interest on debts could be paid by debtors at the contract rate (Tr. p. 44).

During each of its fiscal years ended June 30, 1940 and 1941, petitioner accrued and reported a deduction for interest payable in the amount of $87,016.29. Thereafter from December 4, 1941 to May 11, 1942, petitioner made payments on the principal of its indebtedness in the amount of $160,000. On May 28, 1942, petitioner made another payment of $430,000 of which amount $86,086.98 was credited to interest for the year ended June 30, 1942, and the balance of $343,913.02 was credited to principal of its indebtedness. Hence, as of May 28, 1942, petitioner had made payments of interest in its taxable years 1940, 1941, and 1942 in the total amount of $260,119.59, and payments on principal in the total amount of $503,913.02 (Tr. p. 47).

Subsequently, on June 29, 1942, petitioner entered into a contract with its creditor, Securities and Real Estate Company, whereby the previous payments of principal were then stated to be payments of interest and were reallocated as interest to its taxable years ended June 30, 1940, 1941 and 1942 in the following manner: $92,644.44 was reapplied as an additional payment of interest for the year ended June 30, 1940; $160,000 was reapplied as additional interest for the year ended June 30, 1941; and $251,268.98 was reallocated as additional interest for the petitioner's taxable year ended June 30, 1942. The purpose of that contract, therefore, was to increase the petitioner's original deduction for interest by $503,913.02 and decrease its previous payments on principal by the same amount (Tr. pp. 47 and 48).

For the period July 1 to November 14, 1942, petitioner was engaged in the regular and ordinary business that it had engaged in since July 1, 1911. During the time from July 1 to November 14, 1942, petitioner received gross income from the final liquidation and sales of sugar made during the fiscal year ended June 30, 1942, in the amount of $52,531.37. In the ordinary and necessary course of its business it incurred and accrued expenses in the period July 1-November 14, 1942, in the amount of $311,182 (Tr. p. 50). The income and expenses of the taxpayer for the period July 1st to November 14th, 1942 are clearly reflected by the method of accounting used, within the meaning of Section 41 of the Code; and the return filed for the period was pursuant to the method of accounting employed by petitioner (Tr. pp. 495 to 528).

On November 14, 1942, petitioner transferred all of its property, business and assets to a company of the same name organized under the laws of Cuba. In connection with that reorganization petitioner requested of respondent a ruling under the provisions of Section 112 (i), Internal Revenue Code, to the effect that the proposed transaction described hereinafter is not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes. The respondent replied in part as follows:

> As to the reasons for the proposed transaction, you refer to the provisions of Section Second, Title VI, Article 90 of the Constitution of Cuba, in force since October 10, 1940. That Section provides as follows:
>
> > "The acquisition and possession of land by foreign persons and companies shall be restrictively limited by law, which shall provide measures tending to restore the land to Cubans."
>
> It is apparently your opinion that under the above-quoted provisions of the Constitution, any lands owned

by corporations, as well as individuals, will be expropriated.

* * * * * * *

Based on the facts and circumstances set forth in the application for a ruling, together with the supporting exhibits, it is the opinion of this office that the proposed transaction described above is not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes within the meaning of section 112(i) of the Internal Revenue Code.

The transfer of November 14, 1942, was pursuant to a plan of reorganization as provided by Section 112(g), Internal Revenue Code. The consideration which petitioner received for the transfer of its business, property and assets to the Cuban company was the assumption of debts unpaid at November 14, 1942, together with preferred and common stock of the Cuban company. The stock so received by petitioner was then exchanged for the shares of stock of petitioner, so that, when the transfers and exchanges provided for in the plan of reorganization were completed on November 14, 1942, the persons who were former stockholders of petitioner became the stockholders of the Cuban company (Tr. pp. 50 and 51).

In the return filed by petitioner for its fiscal period June 30, 1943, it reported the gross income received and expenses incurred, accrued and/or paid for the period from July 1 to November 14, 1942, which figures are above set forth. This resulted in the computation of a net loss of $258,650.63 and petitioner claimed this amount as a carry-back credit allowable as a deduction for the fiscal year ended June 30, 1942 under the provisions of Sections 122(b)(1) and 23(s) of the Code (Tr. p. 52).

The respondent allocated $300,000 of petitioner's deduction for business expenses for its fiscal year ended June 30,

1943, to Central Cuba Sugar Company of Cuba under the provisions of Section 45 of the Code (Tr. p. 52).

Petitioner adopted and used the *accrual method* of accounting as distinguished from the cash *receipts* and *disbursements* method; and the accrual method of accounting has been practiced by petitioner throughout its history (Tr. p. 496).

The income and expenses of the "Cuban corporation" that resulted from the reorganization of petitioner at November 14, 1942, are "clearly reflected" by the method of accounting kept by it for the period November 15, 1942 to June 30, 1943, with a resulting net profit of $180,000.00 (Tr. pp. 528 and 529). The reorganization of petitioner at November 14, 1942 was a *bona fide* transaction within the meaning of Section 112(i) of the Internal Revenue Code (Tr. pp. 50 *et seq.*). The Court of Appeals concedes the *bona fides* of the reorganization transaction of November 14, 1942, within the meaning of G.C.M. 27080 of April 23, 1952 (See Appendix "B").

The Court of Appeals purports to make a finding that because of the "fortuitous" effect of the reorganization of petitioner at November 14, 1942, it must be ignored in order to disallow to petitioner the expenses incurred, accrued and/or paid out by it for the period in the amount of $311,182.00. (Tr. p. 50) That pursuant to Section 45 of the Code, an arbitrary amount of $300,000 of the true and correct expenses of the "trade or business" of petitioner for the period July 1-November 14, 1942, must be arbitrarily and/or capriciously allocated to the resulting corporation; so that, the net operating loss of petitioner of $259,650.63 for said period may not be carried-back as a deduction for the taxable year of petitioner ending June 30, 1942, within the meaning of Section 23(s) of the Code. (Tr. p. 52)

The effect of the decision of the Court of Appeals on its "new findings of fact" is to adjudge a "net operating loss" for the resulting corporation of $120,000 for the period November 15, 1942 to June 30, 1943 and a resulting net income of petitioner for the period July 1-November 14, 1942 of $41,349.37; or, a consolidated "net operating loss" of the two trades or businesses for the fiscal year ended June 30, 1943 of $78,560.63. (Tr. pp. 50, 52, 528 and 529)

All of the expenses of $311,182 incurred and accrued in the period July 1-November 14, 1942, were of a *general character* in the trade or business of petitioner (Tr. p. 511) and they were of a nature that required payment as they were incurred, with the exception of some $54,993.46, representing *allowable depreciation* (Tr. p. 518); and an accrued item of $33,071.98 charged for *insurance* on sugar produced in the year ended June 30, 1942 and stored in warehouses. (Tr. p. 521) There was an item of $41,000 incurred and paid for managerial services (Tr. p. 521); and an item of $29,000 for the maintenance of locomotives and freight cars (Tr. p. 520). Such expenses were of a character that *relate back* to the sugar produced by grinding cane for the year ended June 30, 1942, and not to future operations; and with respect to said period the respondent and the Court below propose to allow only the amount of $11,182.00 for such period (Tr. p. 50) by *allocating* $300,000 out of $311,182.00 of such proper expenses (Tr. p. 50). Nothing could be more *arbitrary* and *capricious*, within the meaning of Sections 23(a) and 41 of the Code than is the *allocation* of $300,000 of the expenses of petitioner incurred, accrued and/or paid out in the general operation of its business for the period July 1-November 14, 1942; and the allocation, as proposed, is extremely prejudicial to petitioner with respect to its true and correct tax liability for the period July 1-November 14, 1942, within the meaning of Sections 23(e)(1) and 41 of the Code.

Points Relied Upon

1. Interest accrued at rates fixed by a taxpayer and its creditor for the *use* or *forbearance* of borrowed money is allowable as a deduction, within the meaning of Section 23(b) of the Internal Revenue Code so long as there is a fixed liability for the debt owed for borrowed money.

2. The "net operating loss" of petitioner for the period July 1-November 14, 1942, within its fiscal year ending June 30, 1943, is allowable within the meaning of Sections 23(e)(1) and 41 of the Code; and with respect to the "ordinary and necessary expenses" of petitioner for said period, within the meaning of Section 23(a) of the Code, they may not be allocated to a "resulting corporation" within the meaning of Sections 45 and 112(b) of the Code.

3. The taxable period of a transferor corporation, pursuant to a plan of reorganization within the meaning of Section 112(g) of the Internal Revenue Code, is that part of its fiscal accounting period that has elapsed prior to the effective date of the transfer, within the meaning of Sections 41, 42 and 43 of the Internal Revevnue Code.

4. The final taxable period of petitioner was from July to November 14, 1942, within its fiscal accounting period ending June 30, 1943; and the net operating loss it sustained for such period may be carried back as a deduction for the fiscal year ended June 30, 1942, within the meaning of Sections 23(s) and 122(b) of the Internal Revenue Code.

5. The Court of Appeals, by its decision herein, has subverted and/or sacrificed the clear, plain and obvious meaning of Sections 23(a), (b) and (e)(1) of the Code with respect to a proper determination of the tax liability of a taxpayer for a taxable period; and, in the case of a *bona fide* reorganization of a taxpayer, within the meaning of Section 112(b) and (g) of the Code, it attempts to postpone the effective date thereof —because of the "fortuitous effect" it may have with respect to the tax liability of a transferor taxpayer—

by a *vicarious consolidation* of the transferor taxpayer with the resulting corporation, within the meaning of Section 45 of the Code.

Reasons for Allowance of Writ

On the First Question Presented:

1. The Court below has made an application of the principles of the cases of *Dixie Pine Products Company* v. *Commissioner*, 320 U. S. 516; *Security Flour Mills Company* v. *Commissioner*, 321 U. S. 281 as a basis for its decision herein to disallow a deduction of interest accrued at contract rates for the use or forbearance of borrowed money that is in conflict with the gravamen thereof, as well as Sections 23(b) and 43 of the Code. Those cases did not involve a question of the allowance of *interest* accrued at contract rates for the use or forbearance of borrowed money; but rather, the deduction of a disputed and contested item of expense that the taxpayer denied it owed in the taxable period involved and sought an injunction to prevent its *accrual* as a liability and/or its *collection* at any time. There was no admitted debt liability, in the category of borrowed money, to support the *accrual* claimed in those cases; nor was there involved in those cases any issue as to use or forbearance of borrowed money, pursuant to a moratorium that deferred merely the due date of a fixed liability for borrowed money.

2. The cases that are applicable to a proper decision of the first question presented by this application, in the case of an accrual basis taxpayer, are the cases of *United States* v. *Anderson*, 269 U. S. 422; *American National Company* v. *United States*, 274 U. S. 99; *Luacs* v. *Ox Fibre Brush Company*, 281 U. S. 115; *Brown* v. *Helvering*, 291 U. S. 193; *Clark* v. *Woodward Construction Company*, 179 Fed. (2d) 176 (10th Cir.); and *Zimmerman Steel Company* v. *Commissioner*, 130 Fed. (2d) 1011 (8th Cir.).

3. The cases of *Deputy* v. *Dupont*, 308 U. S. 488; *Zimmerman Steel Company* v. *Commissioner*, 130 Fed. (2d) 1011 (8th Cir.); and *Warner Company* v. *Commissioner*, 181 Fed. 599 (affirming 11 T. C. 419) (3rd Cir.), point out very definitely that the use or forbearance of borrowed money is a proper basis for the *accrual* of interest. The case of *Pierce Estates, Inc.* v. *Commissioner*, 195 Fed. (2d) 475 (3rd Cir.) holds that use of borrowed money supports a liability for *accrued interest* under conditions where *forbearance* may be enforced by the debtor against creditor; and the Court in the *Pierce Estates, Inc.* case, *supra*, refuses to adopt the rule of the case of *Dixie Pine Products Company* and *Security Flour Mills Company, supra*, as holding that forbearance on the part of the creditor is the equivalent of a denial by a debtor of its liability for interest accrued at contract rates in the year the conditions of forbearance become fulfilled, pursuant to a renunciation of the benefits of the moratorium by the debtor. (Tr. p. 446)

4. The basic Moratorium Law of Cuba, insofar as it is pertinent to this proceeding, is Decree Law 412 of August 14, 1934 (Tr. pp. 101 to 302), expiring June 30, 1942. Article 18 thereof (Tr. p. 117) provides:

> "Interest due subsequent to June 30, 1939 shall be paid in accordance with the title documents of the respective (debt) obligations".

5. Under the rules of the Transitory Provisions for the liquidation of the moratorium (being Decree Law 594, Tr. pp. 179, *et seq.*) forbearance with respect to demandable interest accrued at contract rates was made voluntary on the part of the lender of money for use by the debtor, to the extent of 1% per annum of the principal debt in excess of $800,000; but as to contract rates in excess of 1% per annum, the debtor could renounce the benefit of forbearance with respect to interest accrued at contract rates in excess

of 1% per annum of the principal debt. (See Article 19 of Decree Law 663, Tr. p. 368) (See *Home Building & Loan Asso.* v. *Blaisdell*, 290 U. S. 398).

6. The liability of petitioner for interest accrued at contract rates for the use of borowed money was coterminous with its privilege under Article 65 of Decree Law 412 (Tr. p. 142) and/or Article 19 of Decree Law 663 (Tr. p. 368) to waive, relinquish and/or renounce the benefits of forbearance with respect to demand for payment by its creditor; and, because of such conditions under which petitioner had the use of borrowed money, the principles for the *accrual* of interest as a fixed liability are those announced in the cases of *United States* v. *Anderson; American National Company* v. *United States; Lucas* v. *Ox Fibre Brush Company; Brown* v. *Helvering;* and *Deputy* v. *Dupont, supra,* rather than *Dixie Pine Products Company* and *Security Flour Mills Company, supra.*

7. The Court below should not thwart the application of Sections 23(b) and 43 of the Code for the allowance of interest accrued at contract rates for the year ended June 30, 1942, by holding that the agreement of June 29, 1942 (Tr. p. 447) was against the public policy of the United States—although valid between the parties thereto under the Moratorium Laws of Cuba. (See Articles 65 of Decree Law 412 and 19 of Decree Law 663, Tr. pp. 142 and 368.) The Court below may not and should not, for the purpose of escaping the command of Sections 23(b) and 43 of the Code, lift the veil of the status of petitioner as a "domestic corporate person" for the purpose of saying that the deduction of interest accrued would *benefit only* its *alien owners* (Tr. p. 63) and then drop the veil for the purpose of assessing a deficiency tax liability against petitioner as the *alter ego* of its alien owners, with respect to the amount of interest accrued and paid for the use of borrowed money (Tr. p. 43). The decision of the Court below thwarts the

command of Section 23(b) for the allowance of interest accrued at contract rates for the year ended June 30, 1942, and is in direct conflict with the cases of *Dorzback* v. *Collison*, 195 Fed. (2d) 69 (3rd Cir.); *Pierce Estates, Inc., supra* (also 3rd Cir.); and decision of this Honorable Court in *Commissioner* v. *Heininger*, 320 U. S. 467; and *Lilly* v. *Commissioner*, — U. S. — 96 L. Ed. Advance Sheet, Page 385, decided March 10, 1952.

8. The facts stated in and/or underlying the agreement of June 29, 1942 (Tr. p. 446) are stipulated by the parties to be true (Tr. pp. 62, 63 and 64); and they are made the basis of findings of fact by The Tax Court (Tr. pp. 43 and 47). Article 19 of Decree Law 663 (Tr. pp. 357, at Tr. p. 368) sanctions the renunciation of the benefits of the moratorium, as provided in said agreement; and, the right of petitioner to use borrowed money in its business—as found by the Courts below—is an adequate economic factor on which to base Federal tax consequences. (See *Deputy* v. *Dupont*, and *Dorzback* v. *Collison, supra.*)

9. Moreover, inasmuch as the Courts below find that there was a *debt liability* sufficient to support the accrual of interest at contract rates, the case of *Commissioner* v. *Schmoll Fils Associated*, 110 Fed. (2d) 611, does not support the conclusion of the Court below; and with respect to the identity of the *interests* of the corporate persons to the debt agreement, the decision of the Court below is in conflict with the case of *Pierce Estates, Inc., supra*, decided by the Court of Appeals for the Third Circuit.

10. A renunciation of the benefits of the moratorium pursuant to Article 19 of Decree Law 663 (Tr. p. 357—at Tr. p. 368) was necessarily a "paper adjustment" of a formal nature by the agreement of June 29, 1942 (Tr. p. 446); and, inasmuch as the allowance of accrued interest at contract rates of the *debt agreement* for the use or forbearance of borrowed money is not against the public policy of the

United States, as expressed in Section 23(b) of the Code—the agreement of June 29, 1942 (Tr. p. 446) may not be condemned as a matter of law. (See *Deputy* v. *Dupont; Commissioner* v. *Heininger,* 320 U. S. 647; and *Lilly* v. *Commissioner,* — U. S. —, 96 L. Ed. Advance Sheet, Page 385.)

11. The conditions of the agreement of June 29, 1942, with respect to the renunciation of benefits of the Moratorium Laws of *Cuba, became fulfilled* on the day thereof; the agreement was *fully executed,* and therefore needs no further consideration to support it (see *Farrington* v. *Tennessee,* 95 U. S. 679) other than the antecedent debt agreement for the use and forbearance of borrowed money. However, the legal effect of the decision of the Court below, pursuant to its theory that "only one (of the parties to the debt agreement for the use or forbearance of borrowed money) would benefit Federal taxwise," is to lift the "corporate veil" of petitioner as a "domestic person" of the United States and impose a tax upon its nonresident alien owners (Tr. pp. 62 and 63) as to the amount of interest accrued for the use or forbearance of borrowed money from sources outside the United States (Tr. p. 43). Such a theory of the Court below is prejudicial, within the meaning of Section 119 of the Code; and is wholly against the public policy of the United States. (See *Commissioner* v. *Heininger; Lilly* v. *Commissioner, supra; Frick* v. *Pennsylvania,* 268 U. S. 473; and *Treichler* v. *Wisconsin,* 338 U. S. 251.)

12. The position of respondent, as well as the action taken by the Courts below, presents a case where petitioner (as a domestic corporate person of the United States) is denied the equal protection, privileges and/or benefits of the Constitution and laws of the United States, within the meaning of Section 43, Title 8 USCA; and the sole reason assigned by the Courts below for a denial of the benefits that petitioner (in common with other domestic persons of the United States) is entitled to under the provisions of

Sections 23(b) and 43 of the Internal Revenue Code is predicated upon *color of the Moratorium Laws of Cuba* and/or the geographical business situs of petitioner in the State of Cuba (Tr. pp. 42 and 43). Inasmuch as the *place of performance* of petitioner's liability for tax to the United States is at the Collector's office of the United States where its returns are required to be filed, the provisions of Section 23(b) are controlling with respect to the allowance of a deduction of accrued interest at contract rates for the use or forbearance of borrowed money. The Tax Court finds that petitioner used borrowed money in its business, pursuant to forbearance of the Moratorium Laws of Cuba (Tr. p. 43); and inasmuch as the purpose of the forbearance of the Moratorium Laws of Cuba was to permit petitioner in the "*generally* and *extremely profitable operation*" of its trade or business to use borrowed money, the facts underlying the agreement of June 29, 1942 are related to a *good business purpose* of the trade or business of petitioner, within the meaning of Section 23(b) of the Internal Revenue Code. (See *Heininger* v. *Commissioner; Deputy* v. *Dupont;* and *Lilly* v. *Commissioner*, — U. S. —, 96 L. Ed. Advance Sheet, Page 385.)

13. When the Court below undertakes to make a finding of fact from the record for the purpose of reversing the decision of The Tax Court on the second question of this application, it says that The Tax Court overlooked "the true income picture of what was generally an *extremely profitable* operation" of the trade or business of petitioner. (Supp. Tr. Vol. II, p. 10) Therefore, the fact that there is evidence of record to support a finding that the trade or business of petitioner "was generally an extremely profitable operation", it removes petitioner from the ambit of the purpose of a Moratorium Law of forbearance as regards its liability fo raccrued interest at contract rates; and, thereby, lays down the principles of a *good business reason* on the

part of petitioner to renounce the so-called benefits of forbearance as provided by the agreement of June 29, 1942 (Tr. p. 446). Such a finding, while in conflict with *Helvering* v. *National Grocery Company*, 304 U. S. 282, nevertheless demonstrates the arbitrary and capricious attitude of the Courts below to deny to petitioner the equal protection of and/or benefit that Section 23(b) of the Internal Revenue Code confers upon other domestic persons of the United States who find it necessary and/or convenient to use borrowed money in their trade or business and pay interest accrued at reasonable rates for such use or forbearance. (See *Pierce Estates, Inc.* v. *Commissioner;* and *Dorzback* v. *Collison, supra.*)

14. The obligation of petitioner to pay accrued interest at contract rates for the use of borrowed money in its trade or business need not be coterminous with the *legal remedy* of the creditor to forfeit petitioner's right to retain the money borowed, upon its failure to promptly pay interest accrued at contract rates (see *Zimmerman Steel Company, supra*); and the *investiture* of the Moratorium Laws of Cuba of petitioner with *broad powers to retain the borrowed money* for use in its trade or business "during the moratorium period" by no means negatives the *creditor's* ownership of the borrowed money and/or the obligation of petitioner to pay interest for its use at contract rates. (See *Deputy* v. *Dupont, supra.*) The Courts below have sacrificed the "plain, obvious and rational meaning" of Section 23(b) of the Code so as to favor the exigency of the hard case of respondent to find an excuse "under color of the Moratorium Laws of Cuba" for the disallowance of accrued interest. (See *Lynch* v. *Alworth-Stephens*, 267 U. S. 364.)

15. The case of *Poe* v. *Seaborn*, 282 U.S. 101 (75 L. Ed. 239) at page 244 L. Ed., upholds the foregoing principles of law as to the obligation of petitioner to pay accrued interest at contract rates for the use of borrowed money

in its trade or business during the moratorium period, even though *forbearance* of the creditor is somewhat *coerced* by the Moratorium Laws of Cuba.

16. The *Poe* v. *Seaborn case, supra,* involved the obligation of the husband (in the category of a debtor) to pay over to his wife (in the category of a creditor) one-half of the value of *community property* held by him, as well as one-half of the net income therefrom, notwithstanding the policy of the State of Washington to limit the wife's right to call the husband to account in Court for her one-half share of the property and/or one-half of the net income therefrom as earned. That case affords a fair legal basis, on the facts of this case, to recognize the right of petitioner to a deduction of interest accrued at contract rates; and it gives support to the *business purpose* of petitioner at June 29, 1942 to renounce the benefit of forbearance of the Moratorium Laws of Cuba.

17. The Moratorium Laws of Cuba, as found by The Tax Court, do not forbid the *accrual* and/or voluntary payment of *interest accrued* at contract rates for the use of borrowed money during the moratorium period; but they merely provided for forbearance of demand therefor by lender in excess of 1% per annum of the principal of the debt during the moratorium period. (Tr. p. 44.) The liability of a debtor for interest accrued at contract rates during the moratorium period is not affected by the Moratorium Laws of Cuba. It is not even in the category of being usurious, when paid. The doctrine of the cases of *Dixie Pine Products Company* and *Security Flour Mills Company, supra,* is confined to the narrow question as to the deductibility of an *accrued item of expense* for a taxable period during the term of which the taxpayer is involved in a *strenuous* contest with its creditor as to the legal validity of the claim; and, quite properly, this Honorable Court held in those cases that the contested item of ex-

pense did not *accrue* as a *liability* until the year the contest was decided *adversely* to the *taxpayer*. However, the facts underlying the principle of those cases are not present in this proceeding. There was no *controversy* as to the *contract rate of interest* for use of borrowed money; the Moratorium Laws of Cuba *"did not forbid the payment of accrued interest at contract rates"* for the use of borrowed money by a domestic taxpayer of the United States (Tr. p. 44); and the basic principles of the cases of *Dixie Pine Products Company* and *Security Flour Mills Company, supra,* appear to be subverted by the Courts below, as the basis for a *misapplication* of the Moratorium Laws of Cuba, in the case of a *domestic taxpayer* of the United States. The benefits of forbearance that a *domestic taxpayer* of the United States may be entitled to under the Moratorium Laws of Cuba—because of the situs of its trade or business in the State of Cuba—are, if there is need for a comparison, somewhat similar to the benefits of the bankruptcy laws of the United States (see *Zimmerman Steel Company, supra*); and with respect to *analogous* benefits of a domestic taxpayer under the bankruptcy laws of the United States, it is the *public policy* of the United States that *interest accrued* at contract rates for the use of borrowed money be allowed as a deduction in the year of accrual (see *Zimmerman Steel Company, supra; Butler Consolidated Coal Company,* 6 T.C. 183; and *I.T. 3635, C.B. 1944, page 101*). This taxpayer, being a domestic person of the United States, should not be denied the benefit of the public policy of the United States because of the *alien ownership* of its stock, as proposed by the Courts below; and when the Courts of the United States deny to the *alien owners* of a domestic corporate person the full and free benefits of the Constitution and laws of the United States, within the meaning of Section 43, Title 8 USCA, the *Good Neighbor policy* of the United States is infringed

and/or held for naught for the price of taxes improperly proposed for assessment and collection from *funds and property* over which the United States has no jurisdiction (see *Frick* v. *Pennsylvania*, 268 U.S. 473). The Tax Court finds that petitioner has *no property, funds and/or assets situated in the United States.* (Tr. pp. 42 and 43.) However, the domestic taxpayer in this proceeding has, *without exception,* promptly and regularly filed tax returns and paid the taxes due when properly determined and assessed according to the laws of the United States; and the contest over its tax liability as involved in this proceeding presents a question of *public concern,* pursuant to the public policy of the United States. Surely, the *alien ownership* of petitioner should not be held against it as a *domestic person* of the United States.

On the Second Question Presented:

1. The Court below, by reversing the decision of The Tax Court on the issue of the carry-back of a net operating loss, within the meaning of Section 23(s) of the Internal Revenue Code, purports to uphold an abuse of discretion by the Commissioner of Internal Revenue, pursuant to the provisions of Section 45 of the Code. (See G.C.M. 27080, promulgated April 23, 1952—reported Vol. 5 Standard Federal Tax Reporter, Page 40,180, Par. 6181.)

2. The Commissioner of Internal Revenue, with apparent prejudice and caprice, sought to escape the duty imposed upon him by Sections 41, 42 and 43 of the Internal Revenue Code by a resort to the provisions of Section 45 of the Internal Revenue Code; and, inasmuch as the facts found by the Courts below (Tr. p. 52) support fully and adequately the decision of The Tax Court (Tr. pp. 57, 58 and 59), the decision of this Honorable Court in the case of *New Colonial Ice Company* v. *Helvering,* 292 U.S. 435, is controlling.

3. In order for the Commissioner of Internal Revenue to be in a position to resort to the provisions of Section 45 of the Internal Revenue Code, there must be some evidence of tax evasion—short of an attempt to defraud—with respect to the receipt of gross income. (See *Asiatic Petroleum Company* v. *Commissioner of Internal Revenue* (2nd Cir.) 79 Fed. (2d) 234). Or, that the expenses and deductions of a related trade or business (owned by the same interests) are of a departmental character with respect to the gross income produced. (See *Seminole Flavor Company* v. *Commissioner of Internal Revenue*, 4 T.C. 1215; *Koppers Company*, 2 T.C. 152; and *Miles Conley Company*, 10 T.C. 754.)

4. This is the first case in the entire history of the Internal Revenue Code in which the Commissioner of Internal Revenue has attempted to apply the provisions of Section 45 and/or its prototype when a part of Section 240(d) of the Revenue Act of 1921 (42 Stat. 227), or Section 240(f) of the Revenue Act of 1926 (44 Stat. 9), in the case of a resulting corporation under a plan of reorganization. (See *New Colonial Ice Company, supra.*)

5. In order to show what the public policy of the Bureau of Internal Revenue has been in a matter of this kind, G.C.M. 27080 referred to above is copied in full as an appendix hereto. Furthermore, with respect to the public reaction to the decision of the Court below on this question of the application, the "Tax Barometer", a Weekly Interpretation of Federal Tax News, (444 Madison Avenue, New York 22, N. Y.) has this to say, viz:

> "In cases like Jud Plumbing, supra, and Standard Paving Co., C.A. 10th, 190 F. (2nd) 330, Bar., V. 8, Par. 475, cited by the Court here, income was attributed to the taxpayer which had earned it—a fair application of a fair doctrine—that the fruits are not to be attributed to a different tree from that on which they

grew (Lucas v. Earl, 28 U.S. 111). Here, there seems to be a perversion of that doctrine. Sec. 45 permits the Commissioner to allocate income, deductions, credits, etc., among taxpayers owned or controlled directly or indirectly by the same interests in order to prevent the evasion of taxes or clearly to reflect income. It would seem one thing to say, under Sec. 45, that expenditures claimed by one of several related entities were the expenditures of another of the entities because of facts indicating that to be the reality of the situation and that reporting of the expenditures by the other entity was erroneous (C. F. Chelsea Products, Inc., C.A. 3rd, Bar., V. 9, Par. 636). It would seem totally different to say that the expenditures of one entity shall be attributed to another which was not even in existence when the expenditures were incurred. That, in effect, attributes the fruit to a tree other than that on which it grew."

6. The Tax Court makes findings of fact (Tr. pp. 50, 51 and 52) that are sufficiently full and adequate to support its conclusions at pages 57, 58 and 59 of the transcript, pursuant to the principles of the case of *New Colonial Ice Company* v. *Helvering*, 292 U.S. 435; but the Court below purports to make its own "findings of fact", contrary to the principles of the cases of *Helvering* v. *National Grocery Company*, 304 U.S. 282; *Helvering* v. *Rankin*, 295 U.S. 123; and *Elmhurst Cemetery Company* v. *Commissioner*, 300 U.S. 37, and takes The Tax Court to task with respect to proper conclusions of law by saying:

> "The Tax Court's assumption of the necessity of finding some ulterior motivation—traditionally a thankless task in tax cases and one to be avoided if possible—was error." (Supp. Tr., Vol. II, p. 10)

7. The Court below purports to make the following findings of fact as a basis of upholding the arbitrary and capricious conduct of respondent, viz:

> "• • • The claimed reason and justification for the order are rather that to divide the fiscal year in November distorts the true income picture of what was generally an extremely profitable operation. The reorganization occurred at a time when substantial expenses had been incurred 'in getting ready for the next spring grinding season,' but before the year's crop had been sold and income recorded, which occurs from January to March. Hence the Commissioner contends that irrespective of tax evasion, the reallocation of the deductions was necessary and proper under I. R. C. Sec. 45 'clearly to reflect the income.'"

8. The case of *Asiatic Petroleum Company* v. *Commissioner*, 79 Fed. (2d) 234, is to be distinguished from the facts of this case as a basis for the application of Section 45 of the Internal Revenue Code; and none of the other cases relied upon by the Court purport to apply the principles of Section 45 of the Internal Revenue Code to the underlying facts thereof. The case of *United States* v. *Lynch*, 192 Fed. (2d) 718, was decided upon the basis of the accounting method employed—pursuant to the provisions of Section 41 of the Code.

9. The Tax Court finds (Tr. p. 57) that the accounting method employed by petitioner for the taxable period July 1st to November 14th, 1942, within its fiscal year ended June 30, 1943, was adequate and proper within the meaning of Sections 41, 42 and/or 43 of the Code, so as to "clearly reflect income" as provided by each of said sections; and when The Tax Court makes a proper conclusion of law that is fully supported by its findings of fact, the functions of an Appellate Court are limited to the ascertainment of whether there was evidence to support the findings and decision of The Tax

Court. (See *Helvering* v. *National Grocery Company, supra; Commissioner* v. *Mnookin's Estate,* 184 Fed. (2d) 89.)

10. The Court below purports to invade the functions of The Tax Court to draw inferences, to *weigh evidence,* and to declare the results, contrary to the case of *Hulburd* v. *Commissioner,* 296 U. S. 300; and when The Tax Court says that,

> "We believe that under the circumstances of this case, where a sound reason not primarily related to tax saving was the motivating force of the transaction in question, the respondent should not be permitted, under the guise of section 45, to allocate certain of the expenses of the petitioner to the Cuban corporation. *Miles Conley Co.,* 10 T.C. 754, 762, 763."

it would appear that the judgment of the Court below to reverse the decision of The Tax Court on this issue of the case is clearly in conflict with the cases of *Hulburd* v. *Commissioner, supra,* and *Commissioner* v. *Mnookin's Estate,* 184 Fed. (2d) 89.

11. The *bona fides* of the reorganization transaction of petitioner at November 14, 1942 (Tr. pp. 50, 51) is conceded by respondent (Supp. Tr., Vol. II, p. 10). Therefore, the principles of the case of *New Colonial Ice Company,* and G.C.M. 27080 must be recognized; and under the principles of the case of *Acampo Winery & Distillery Company* v. *Commissioner,* 7 T.C. 629, petitioner is entitled to the provisions of Section 23(s) of the Code. The Tax Court so finds and holds, and when the Court of Appeals undertakes to reverse the decision of The Tax Court—on the facts as found by The Tax Court—the Court of Appeals merely substitutes its conclusions for those of The Tax Court and/or compels The Tax Court to adopt its findings of fact as a basis of a decision to be entered on the mandate issued.

12. In the light of the cases of *Helvering* v. *National Grocery Company,* 304 U.S. 282; *Helvering* v. *Rankin,* 295 U.S.

123; *Hulburd* v. *Commissioner*, 296 U.S. 300; and *Elmhurst Cemetery Company* v. *Commissioner*, 300 U.S. 37, the Court of Appeals herein has acted arbitrarily and capriciously in the matter of the application of Section 45 of the Code—and has done so in the teeth of the findings of fact by The Tax Court and its decision upon all the evidence. The decision of The Tax Court makes out a conclusive case of the inapplicability of Section 45 of the Code; and having found as a fact that the accounting method of petitioner—pursuant to the provisions of Sections 41, 42 and 43 of the Code—is adequate to "clearly reflect income", the decision of The Tax Court is conclusive on the Commissioner's appeal therefrom. (See *Commissioner* v. *Mnookin's Estate, supra.*)

13. When The Tax Court approved the accounting method of petitioner with respect to its final taxable period of July 1st to November 14th, 1942, within the fiscal year ending June 30, 1943, as regards the allowance of expenses incurred, *accrued and/or paid* in that period, it did so upon *all the evidence* of record; and, from its findings of fact, The Tax Court may properly say that under the circumstances the respondent should not be permitted, under the guise of Section 45 of the Code, to allocate *certain* of the expenses of the petitioner to the Cuban corporation. The Tax Court found that the accounting method of petitioner for the period July 1st to November 14th, 1942, within the fiscal year ending June 30, 1943, "clearly reflects income" (Tr. pp. 50 and 52); and the result so declared means that the respondent may not, under the guise of Section 45 of the Code, disallow a deduction of the carry-back loss of $258,650.63 as provided by Section 23(s) of the Code. The principles of *New Colonial Ice Company* v. *Helvering, supra*, prevent a carry-forward of any part of the net operating loss as a deduction by the resulting corporation, pursuant to a plan of reorganization; and the decision of the Court of

Appeals herein cannot escape being in conflict with the case of *New Colonial Ice Company, supra,* as a matter of law.

14. The decision of the Court of Appeals herein—being in effect the result of a *de novo* hearing by it on this issue of the case—is flagrantly in conflict with the case of *Helvering* v. *National Grocery Company, supra;* and it magnifies, as a matter of law, the arbitrary and capricious conduct of respondent to use Section 45 of the Code as a guise to disallow the carry-back of a net operating loss within the meaning of Section 23(s) of the Code, as found by The Tax Court upon *all the evidence.*

15. The judgment of the Court of Appeals on this issue of the case upsets a long established practice of the Bureau, as indicated by G.C.M. 27080, *supra;* and, insofar as it applies to the facts of this case—as found and declared by The Tax Court—it demonstrates a prejudice on the part of an Appellate Court that is intolerable under the principles of the case of *Helvering* v. *National Grocery Company, supra,* with respect to the future administration of Section 45 of the Code. The judgment of the Court of Appeals tends to upset the meaning and/or purpose of Section 45 of the Code as heretofore settled and acquiesced in by a long line of cases, among which are: *Seminole Flavor Company,* 4 T.C. 1215; *Koppers Company,* 2 T.C. 152; and *Miles Conley Company,* 10 T.C. 754. Section 141 of the Code does not permit the *transferor* and the *resulting corporation* of a *bona fide* reorganization transaction (within the meaning of Section 112(b) and (i) of the Code) to file consolidated returns; and they may not be ordered to do so vicariously within the meaning of Section 45 of the Code.

16. The true legal result of the decision of the Court of Appeals, based upon its independent findings of fact, is that "net operating loss" of the "trade or business" of petitioner for its "fiscal year ended June 30, 1943" is $78,650.63

instead of $258,650.63, as found by The Tax Court (Tr. p. 52). The Court of Appeals appears to stop short of the duty required of it, in its vicarious position as an administrative agency of the Bureau of Internal Revenue under the provisions of Sections 41, 42, 43 and 45 of the Code, with respect to a determination of the "true and correct net income and expenses of the *trade* or *business* of petitioner for the fiscal year ended June 30, 1943"; for the reason, that if there be a *practical* and/or *legal* basis for the decision *ordered* by the Court of Appeals, the provisions of Section 23(s) must be applied to a carry-back of the net operation loss of $78,650.63 of the trade or business of petitioner for the fiscal year ended June 30, 1943. The Court of Appeals purports to decree a postponement of the *effective* date of the reorganization of petitioner from November 14, 1942 to June 30, 1943 with respect to $300,000 of the ordinary and necessary expenses incurred and accrued for the period July 1-November 14, 1942; and if that may be done for the "allocation" proposed, the result must be given its true effect within the meaning of Sections 23(s) and 122(b) of the Code. The *arbitrary* and *capricious* conduct of respondent, as evidenced by the findings of fact of The Tax Court, is not cured—as proposed by the Court of Appeals; but rather is magnified, when the inevitable inference drawn by The Tax Court *from all of the evidence* is ignored. (See *Helvering* v. *National Grocery Company*, and *Helvering* v. *New Colonial Ice Company*, *supra*.)

17. The apparent vice that is inherent in the *decision ordered* by the Court of Appeals is that *depreciation* of $54,993.46 sustained in the period July 1-November 14, 1942 is *allocated* as a deduction of the resulting corporation; as well as $33,071.98 incurred and accrued as a premium for insurance on stored sugar, produced for the year of petitioner ended June 30, 1942. This is definitely in conflict with the principles of the cases of *Dixie Pine Products Company*

and *Security Flour Mills Company, supra;* and the decision of the Court of Appeals that the "allocation ordered" by respondent be upheld by The Tax Court has the effect of postponing the *effective* date of the *reorganization* of petitioner at November 14, 1942, within its fiscal year ended June 30, 1943, in violation of the principles of *New Colonial Ice Company, supra.* The exigency of the hard case of respondent to sustain the arbitrary and capricious allocation proposed should not be favored by a sacrifice of the principles of the case of *New Colonial Ice Company, supra,* now adopted as the unwavering practice of the Bureau by G.C.M. 27080. The Court of Appeals fails to say that the decision of The Tax Court on this issue of the case is erroneous "upon all the evidence of the case"; but merely says The Tax Court was in error, according to the views of the Court of Appeals, "as to weight of the evidence". (See *Helvering* v. *National Grocery Company, supra.*)

18. The purported "new findings of fact" by the Court of Appeals that $300,000 of the expenses incurred, accrued and/or paid in the regular trade or business of petitioner for the period July 1-November 14, 1942, "was primarily with respect to future operations of the trade or business of petitioner by the *resulting corporation of the reorganization transaction*" is without evidentiary support in the record; and insofar as there were ordinary and necessary expenses incurred, accrued and/or paid in that period, they were of a deductible character, within the meaning of Section 23(a) (and resulted in a net operating loss, within the meaning of Section 23(e)(1) of the Code) no matter in what medium of exchange the consideration received for a transfer of capital assets (in the reorganization transaction) may have been paid and/or recognized as the equivalent of cash for the computation of capital gain or loss. (See Section 117(j), Internal Revenue Code, effective for year 1942.) There

should be no vicarious *recognition* of gain, within the meaning of Section 112(b) of the Code so as to disguise the *disallowance* of a "net operating" loss of $258,650.63 within the meaning of Section 23(e)(1) of the Code; and then confuse the action taken by saying it is sustained by Section 45 of the Code.

19. The Court of Appeals proposes for the first time in the history of the "income tax law" the denial of an "operating loss" within the meaning of Section 23(e)(1) of the Code in a case where there is no "matching gross income" of an equal amount for a taxable period; and as regards the net "operating loss" of petitioner of $258,650.63 for the period July 1-November 14, 1942, within the fiscal year ended June 30, 1943, the provisions of Section 23(h) of the Code appear to be applied to the trade or business of petitioner rather than Section 45 of the Code. (See *Humphrey* v. *Commissioner*, 162 Fed. (2d) 853 (5th Cir.), and *Skeeles* v. *United States*, 118 Ct. Cl. 362 (95 Fed. Supp. 242).) The ordinary and necessary business expense of the trade or business of a taxpayer, within the meaning of Sections 23(a), (e)(1) and 41 of the Code, accrued and/or paid in a taxable period within the meaning of Section 43 of the Code—as found by The Tax Court herein—may not be allocated to another within the meaning of Section 45 of the Code; and any attempt to make an allocation of such expense is not only an *abuse of discretion*, but is arbitrary, capricious and prejudicial. (See *Seminole Flavor Company; Koppers Company;* and *Miles Conley Company, supra.*)

WHEREFORE, petitioner prays that a writ of certiorari be issued to the United States Court of Appeals for the Second Circuit to review the Judgment of the Courts below in this proceeding; that the conflicts appearing be reconciled; that that the procedure for the allowance of accrued interest for the use or forbearance of borrowed money be uniformly

administered with respect to all domestic persons, within the meaning of Section 23(b) of the Code; that the arbitrary and capricious application of Section 45 of the Code, as proposed by the Court of Appeals herein, be restrained so as to conform to long and well established practice and procedure therefor; and that petitioner be granted redress with respect to the benefits, rights and privileges that it is entitled to "in common with other domestic persons" under the Constitution and laws of the United States, within the meaning of Section 43, Title 8, USCA.

Respectfully,

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APPENDIX A

STATUTES AND REGULATIONS INVOLVED

STATUTES:

Section 23(a), (b) and (s) of the Internal Revenue Code provides as follows:

> In computing net income there shall be allowed as deductions
>
> . . . . . .
>
> (a) EXPENSES.—All ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered.
>
> (b) INTEREST.—All interest paid or accrued within the taxable year on indebtedness, except on indebtedness incurred or continued to purchase or carry obligations (other than obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer) the interest upon which is wholly exempt from the taxes imposed by this chapter.
>
> . . . . . .
>
> (s) For any taxable year beginning after December 31, 1939 the net operating loss deduction computed under Section 122.

Section 41 of the Internal Revenue Code provides as follows:

> The net income shall be computed upon the basis of the taxpayer's annual accounting period(fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been employed, or if the method employed does not clearly reflect the income, the compu-

tation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. If the taxpayer's annual accounting period is other than a fiscal year as defined in section 48 or if the taxpayer has no annual accounting period or does not keep books, the net income shall be computed on the basis of the calendar year.

Section 42 of the Internal Revenue Code provides as follows:

(a) GENERAL RULE.—The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under section 41, any such amounts are to be properly accounted for as of a different period. In the case of the death of a taxpayer whose net income is computed upon the basis of the accrual method of accounting, amounts (except amounts includible in computing a partner's net income under section 182) accrued only by reason of the death of the taxpayer shall not be included in computing net income for the period in which falls the date of the taxpayer's death.

Section 43 of the Internal Revenue Code provides as follows:

The deductions and credits (other than the corporation dividends paid credit provided in section 7) provided for in this chapter shall be taken for the taxable year in which "paid or accrued" or "paid or incurred," dependent upon the method of accounting upon the basis of which the net income is computed, unless in order to clearly reflect the income the deductions or credits should be taken as of a different period. In the case of the death of a taxpayer whose net income is computed upon the basis of the accrual method of accounting, amounts (except amounts includible in computing a partner's net income under section 182) accrued as deductions and credits only by reason of the death of the taxpayer shall not be allowed in computing

net income for the period in which falls the date of the taxpayer's death.

Section 45 of the Internal Revenue Code provides as follows:

> In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled, directly or indirectly by the same interests, the Commissioner is authorized to distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.

Section 12(a) and (b) of the Internal Revenue Code provides as follows:

> (a) DEFINITION OF NET OPERATING LOSS.—
>
> As used in this section, the term "net operating loss" means the excess of the deductions allowed by this chapter over the gross income with the exceptions, *additions*, and limitations provided in subsection (d).
>
> (b) AMOUNT OF CARRY-BACK AND CARRY-OVER.—
>
> (1) NET OPERATING LOSS CARRY-BACK.—If for any taxable year beginning after December 31, 1941, the taxpayer has a net operating loss, such net operating loss shall be a net operating loss carry-back for each of the two preceding taxable years, except that the carry-back in the case of the first preceding taxable year shall be the excess, if any, of the amount of such net operating loss over the net income for the second preceding taxable year computed (A) with the exceptions, additions, and limitations provided in subsection (d) (1), (2), (4), and (6), and (B) by determining the net operating loss deduction for such second preceding

taxable year without regard to such net operating loss.

(2) NET OPERATING LOSS CARRY-OVER.—If for any taxable year the taxpayer has a net operating loss, such net operating loss shall be a net operating loss carry-over for each of the two succeeding taxable years, except that the carry-over in the case of the second succeeding taxable year shall be the excess, if any, of the amount of such net operating loss over the net income for the intervening taxable year computed (A) with the exceptions, additions, and limitations provided in subsection (d)(1), (2), (4), and (6), and (B) by determining the net operating loss deduction for such intervening taxable year without regard to such net operating loss and without regard to any net operating loss carry-back. For the purposes of the preceding sentence the net operating loss for any taxable year beginning after December 31, 1941 shall be reduced by the sum of the net income for each of the two preceding taxable years (computed for each such preceding taxable year with the exceptions, additions, and limitations provided in subsection (d)(1), (2), (4), and (6), and computed by determining the net operating loss deduction without regard to such net operating loss or to the net operating loss for the succeeding taxable year).

REGULATIONS:

Section 29.23(a)-1 of Regulations 111 provides as follows:

BUSINESS EXPENSES.—Business expenses deductible from gross income include the ordinary and necessary expenditures directly connected with or pertaining to the taxpayer's trade or business, except the classes of items which are deductible under sections 23(b) to 23(s), inclusive, and the regulations thereunder. Double deductions are not permitted. Amounts deducted under one provision of the Internal Revenue Code cannot again be deducted under any other provision thereof. As to charitable contributions by corporations not deductible under section 23(a), see section

29.23(a)-13. The cost of goods purchased for resale, with proper adjustment for opening and closing inventories, is deducted from gross sales in computing gross income. (See section 29.22(a)-5.) Among the items included in business expenses are management expenses, commissions, labor, supplies, incidental repairs, operating expenses of automobiles used in the trade or business, traveling expenses while away from home solely in the pursuit of a trade or business (see section 29.23(a)-2), advertising and other selling expenses, together with insurance premiums against fire, storm, theft, accident, or other similar losses in the case of a business, and rental for the use of business property. Penalty payments with respect to Federal taxes, whether on account of negligence, delinquency, or fraud, are not deductible from gross income. The full amount of the allowable deduction for ordinary and necessary expenses in carrying on a business is nevertheless deductible, even though such expenses exceed the gross income derived during the taxable year from such business.

Section 29.23(b)-1 of Regulations 111 provides as follows:

> Interest paid or accrued within the year on indebtedness may be deducted from gross income, except that interest on indebtedness incurred or continued to purchase or carry obligations, such as municipal bonds, Panama Canal loan 3 percent bonds, or (in case of a taxpayer not an original subscriber) obligations of the United States issued after September 24, 1917, the interest upon which is wholly exempt from tax, is not deductible. Interest paid or accrued within the year on indebtedness incurred or continued to purchase or carry (a) obligations of the United States issued after September 24, 1917, the interest upon which is not wholly exempt from the taxes imposed by chapter 1, or (b) (in the case of an original subscriber) obligations of the United States issued after September 24, 1917, the interest upon which is wholly exempt from the taxes

imposed by chapter 1, is deductible in accordance with the general rule.

Interest paid by the taxpayer on a mortgage upon real estate of which he is the legal or equitable owner, even though the taxpayer is not directly liable upon the bond or note secured by such mortgage, may be deducted as interest on his indebtedness. Payments of Maryland or Pennsylvania ground rents are deductible as interest if the ground rent is redeemable, but are treated as rent if the ground rent is irredeemable and in such case are deductible only to the extent they constitute a proper business expense.

Section 29.41-1 of Regulations 111 provides as follows:

Net income must be computed with respect to a fixed period. Usually that period is 12 months and is known as the taxable year. Items of income and of expenditure which as gross income and deductions are elements in the computation of net income need not be in the form of cash. It is sufficient that such items, if otherwise properly included in the computation, can be valued in terms of money. The time as of which any item of gross income or any deduction is to be accounted for must be determined in the light of the fundamental rule that the computation shall be made in such a manner as clearly reflects the taxpayer's income. If the method of accounting regularly employed by him in keeping his books clearly reflects his income, it is to be followed with respect to the time as of which items of gross income and deductions are to be accounted for. (See sections 29.42-1 to 29.42-3, inclusive). If the taxpayer does not regularly employ a method of accounting which clearly reflects his income, the computation shall be made in such manner as in the opinion of the Commissioner clearly reflects it.

Section 29.43-1 Regulations 111 provides:

(a) The terms "paid or incurred" and "paid or accrued" will be construed according to the method of accounting upon the basis of which the net income

is computed by the taxpayer. (See section 48 (c).) The deductions and credits provided for in chapter 1 (other than the dividends paid credit provided in section 27) must be taken for the taxable year in which "paid or accrued" or "paid or incurred", unless in order clearly to reflect the income such deductions or credits should be taken as of a different period. If a taxpayer desires to claim a deduction or a credit as of a period other than the period in which it was "paid or accrued" or "paid or incurred", he shall attach to his return a statement setting forth his request for consideration of the case by the Commissioner together with a complete statement of the facts upon which he relies. However, in his income tax return he shall take the deduction or credit only for the taxable period in which it was actually "paid or incurred", or "paid or accrued", as the case may be. Upon the audit of the return, the Commissioner will decide whether the case is within the exception provided by the Internal Revenue Code, and the taxpayer will be advised as to the period for which the deduction or credit is properly allowable.

Section 29.122-2 of Regulations 111 provides:

"COMPUTATION OF NET OPERATING LOSS IN CASE OF CORPORATION.—A net operating loss is sustained by a corporation in any taxable year if and to the extent that, for such year, there is an excess of deductions allowed by chapter 1 over gross income, both computed with the following exceptions, additions and limitations:

(1) The deduction for depletion shall not exceed the amount which would be allowable if computed without reference to discovery value or to percentage depletion under section 114(b) (2), (3), or (4);

(2) There shall be included in computing gross income the amount of interest received which is wholly exempt from the taxes imposed by chapter 1, decreased by the amount of interest paid or accrued which is not

allowed as a deduction by section 23(b), relating to interest on indebtedness incurred or continued to purchase or carry certain tax-exempt obligations;

(3) No net operating loss deduction shall be allowed;

(4) For any taxable year beginning after December 31, 1938, and before January 1, 1942, the amount deductible on acount of long-term capital losses shall not exceed the amount includible on account of long-term capital gains, and the amount deductible on account of short-term capital losses shall not exceed the amount includible on account of short-term capital gains. For any taxable year beginning after December 31, 1941, the amount deductible on account of losses from sales or exchanges of capital assets shall not exceed the amount includible on account of gains from sales or exchanges of such assets; and

(5) For taxable years beginning after December 31, 1941, there shall be allowed as a deduction the amount of excess profits tax imposed by subchapter E of chapter 2 paid or accrued within the taxable year, subject, however, to the provisions of section 122(d) (6) (A), (B), and (C).

MORATORIUM LAWS:

The provisions of the Moratorium Laws of Cuba that are pertinent to this proceeding are:

Article 18 of Decree Law 412 (Tr. p. 117), viz:

Interest due subsequent to June 30, 1939, shall be paid in accordance with the title documents of the respective obligations, and the amounts of principal which according to said title documents mature subsequent to that date shall be paid in the following manner:

Articles 65, 66 and 67 of Decree Law 412 (Tr. pp. 142 and 143) viz:

ARTICLE 65. Debtors shall be entitled to waive the benefits of this law, but that waiver, except as

provided in Article 67, shall not be efficacious unless it meets the following requirements:

1st. That it be express and subsequent to its promulgation.

2nd. That it be made in writing, in a form which is prima facie evidence in court.

3rd. That it be of a general character. This requirement shall be deemed to be complied with in either of these cases: a) If the waiver comprise all the obligations subject to moratorium which may be enforced against the debtor. b) When it extends to all the benefits of this Law in connection with specified properties of the person making the waiver.

4th. That it does not prejudice the rights of a third party.

Article 66. *Debtors who have taken advantage of the moratorium can make voluntary payments on account of principal or interest if it suits them to do so, but such payments shall be adjusted to the following rules:*

a) The creditor can not be compelled to receive amounts which do not represent one or more complete and matured instalments of principal or interest, in accordance with the title documents of the respective obligations, or the balance of one partially paid. The requirement of maturity shall not be enforceable when the debtor is authorized to make payment ahead of time.

b) Neither can he be compelled to accept amounts on account of the principal if interest due is pending, except as provided in Article 60.

Article 67. The tacit waiver of the benefits of this law which is presumed from the making of voluntary payments shall be understood as limited exclusively to the amounts paid in excess of those demandable, which, if the debtor shall so require at any time during the life of this law, shall be considered as advance instalments on account of the unavoidable payments which in future must be made in accordance with its provisions.

Article 19 of Decree Law 663 (Tr. pp. 368 and 369), viz:

> In order that renunciation of the benefits of the Transitory Provision can be efficacious, it must meet the following requisites:
>
> 1st. That it be express and subsequent to promulgation of said Provision.
>
> 2nd. That it be reduced to writing in a legally-sufficient form.
>
> 3rd. That it be general in character. This requisite shall be deemed to be met in any of the following cases:
>
> a) If the renunciation comprises all obligations subject to the Transitory Provision, that are exactable from the debtor.
>
> b) When it applies to all benefits of the Transitory Provision with reference to certain properties of the renouncer.
>
> 4th. That it does not prejudice the rights of a third person.

APPENDIX B

(6181) G. C. M. 27080, 1952-8-13802 (p. 8).

Separate taxable corporate entities: Organization of new corporation upon expiration of charter of old corporation: No change in stockholdings.—A corporation was organized under the laws of a certain State, its corporate life being fixed in the charter at 30 years. The expiration of the 30-year period was not discovered until a short time thereafter, at which time a new corporation was organized under the laws of the same State, with the same name and capital structure. The assets of the old corporation were then conveyed to the new corporation in exchange for the capital stock of the latter, the stock certificates being issued to the stockholders of the old corporation in the same ratio and amount as their stockholdings in that corporation. *Held*, for Federal income tax purposes, the two corporations should be treated as separate and distinct taxable entities

which are required to file separate Federal income tax returns.

S. M. 4947A (C. B. V-2, 120 (1926)) modified.

Back reference: Sec. 29.52-1 at 522 CCH 462.233.

An opinion is requested whether separate and distinct corporate entities are to be recognized, for Federal income tax purposes, under the circumstances hereinafter stated.

In the instant case, a corporation had been organized under the laws of a certain State, its corporate life being fixed in the charter at 30 years. The expiration of the 30-year period was not discovered until a short time thereafter, at which time a new corporation was organized under the laws of the same State, with the same name and capital structure. The assets of the old corporation were then conveyed to the new corporation in exchange for the capital stock of the latter, the stock certificates being issued to the stockholders of the old corporation in the same ratio and amount as their stockholdings in that corporation.

S. M. 4947A (C. B. V-2, 120 (1926)) holds in part and in effect that where, by reason of the expiration of the charter of a corporation, it became necessary to organize a new corporation under the laws of the same State with the same corporate powers and the same stockholdings as those in the old corporation, the new corporation is, for taxing purposes, a continuation of the corporate entity of the old corporation, and that only one income tax return is required. It is believed, however, that such conclusions should no longer be followed in view of the principles set forth in *New Colonial Ice Co., Inc.* v. *Helvering* (292 U. S. 435; Ct. D. 841, C. B. XIII-1, 194 (1934) (4 USTC 1292)).

In the *New Colonial Ice Co.* case, a corporation, pursuant to a reorganization agreement, transfered its assets, liabilities, and business on April 13, 1922, to a new corporation organized under the laws of the same State, after which transfer the new corporation had substantially the same stock, stockholdings, corporate powers, and business as the old corporation. During 1921 and the part of 1922 preceding the transfer, the old corporation had sustained statutory net losses which the new corporation, attempting to treat itself as a continuation of the old corporate entity,

claimed as a deduction from its income realized during 1922 and 1923. The Court held that the two corporations were separate and distinct corporate entities, basing its opinion on the fact that there was a voluntary and contractual transfer, not by operation of law, of assets and business from one corporation to the other.

In *Weber Flour Mills Co.* v. *Commissioner* (82 Fed. (2d) 764 (36-1 USTC 9207)), a case not involving a reorganization, a corporation was created upon the expiration of the charter of its predecessor corporation, and all of the assets and the business of the old corporation were transferred to the new corporation. The new corporation, organized under the laws of the same State, had precisely the same capital structure as that of the old corporation. The court followed the principles and conclusions in the *New Colonial Ice Co.* case and held that the two corporations were separate taxable entities.

In view of the foregoing, it is the opinion of this office that, for Federal income tax purposes, the two corporations in the instant case should be treated as separate and distinct taxable entities which are required to file separate Federal income tax returns. Accordingly, S. M. 4947A, *supra,* is hereby modified. (Signed by Mason B. Leming, Acting Chief Counsel, Bureau of Internal Revenue.)

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In the Supreme Court of the United States

OCTOBER TERM, 1952

No. 332

CENTRAL CUBA SUGAR COMPANY, *Petitioner*

v.

COMMISSIONER OF INTERNAL REVENUE

On Petition For a Writ of Certiorari to the United States Court of Appeals For the Second Circuit

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BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the Tax Court (I R. 40-60)[1] is reported at 16 T.C. 882. The opinion of the Court of Appeals (II R. 8-15) is reported at 198 F. 2d 214.

JURISDICTION

The judgment of the Court of Appeals was entered on July 7, 1952 (II R. 15). A petition for

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[1] The record consists of two volumes, which will be indicated by "I R." and "II R."

a writ of certiorari was filed on September 12, 1952. The jurisdiction of this Court is invoked under 28 U.S.C., Section 1254.

QUESTIONS PRESENTED

1. The taxpayer owed a large indebtedness to a related corporation in Cuba. Under moratorium provisions effective in Cuba, the taxpayer was obligated to pay interest at no more than one percent per year.

The question is whether the lower courts correctly held that the taxpayer could not accrue as an interest deduction an amount in excess of its obligation under the moratorium laws of Cuba, and that the amount accruable as interest was not altered by a later agreement between the taxpayer and its related corporation which, in an effort to secure a larger tax deduction, purported to reallocate prior principal payments to interest.

2. The taxpayer, engaged in a seasonal business, transferred its assets and business to a related corporation which continued to conduct the business. The transfer, which was tax-free, took place in the middle of the year after a considerable portion of the year's expenses had been incurred and prior to the time that the year's income would be realized. In order to reflect the taxpayer's income clearly, the Commissioner, under Code Section 45, allocated a considerable portion of the taxpayer's expenses to the successor corporation.

The question is whether the Court of Appeals was correct in holding that the Commissioner is empowered to make such an allocation of expenses to achieve a clear reflection of the taxpayer's income and in holding that the Tax Court had erred in refusing to uphold the allocation merely because the taxpayer had not been motivated by tax avoidance purposes.

STATUTE AND REGULATIONS INVOLVED

The applicable provisions of the statute and Regulations involved are set forth in the Appendix, *infra*, pp. 17-23.

STATEMENT

1. During the pertinent period, the taxpayer was indebted to Securities and Real Estate Company (which will be called Securities), a Cuban corporation whose stock was owned by the same persons who were the taxpayer's stockholders. The indebtedness consisted of $3,815,334.24, evidenced by first mortgage bonds (the balance remaining out of an original mortgage indebtedness of $5,000,000), bearing interest at five percent per year, and of an unsecured loan of $4,886,295.19, bearing interest at three percent per year. Both of these obligations had been incurred prior to August 10, 1934. (I R. 43-44, 54, 62-64.)

On August 14, 1934, a general moratorium was enacted in Cuba relative to the payment of interest and principal on obligations. (Decree-Law 412,

Pet. Ex. 8, I R. 101-158.) Prior to the termination of this moratorium, the Cuban Constitutional Convention in June, 1940, adopted a Transitory Provision (Pet. Ex. 8, I R. 303-319) which had the effect of extending the moratorium so that, in the case of obligations in excess of $50,000, the principal was to be amortized by annual installments beginning on June 30, 1942, and extending until June 30, 1970 (I R. 304). An indebtedness in excess of $800,000 was to bear interest at a rate of one percent per year. (I R. 305.) Implementing regulations were promulgated on February 26, 1941 (Decree No. 663, Pet. Ex. 8, I R. 357-409), which provided, among other things, for the manner in which a debtor could renounce the benefits of the Transitory Provision (Decree No. 663, *supra*, Art. 19, I R. 368-369). In the absence of such a renunciation, interest at the contract rate was not merely deferred but the debtor had no obligation to pay interest in excess of the moratorium rate.

In its tax return for the fiscal year ended June 30, 1940, the taxpayer claimed a deduction of $87,016.29 as interest accrued on the indebtedness to Securities, the amount being computed at one percent on the total indebtedness. This amount, which was also accrued on the taxpayer's books, was paid as interest by the taxpayer to Securities on November 29, 1941. During the fiscal year ended June 30, 1941, the taxpayer also accrued

and paid interest of $87,016.29, calculated at one percent on this indebtedness. Between December 4, 1941, and May 11, 1942, the taxpayer paid $160,000 on the principal of the unsecured indebtedness of $4,886,295.19. For the fiscal year ended June 30, 1942, it accrued and paid interest of $86,086.98, calculated at one percent of the total indebtedness, as reduced by the $160,000 payment mentioned above. This interest payment was included in a check for $430,000, dated May 28, 1942, to Securities, $343,913.02 being applied as a further reduction of principal on the indebtedness of $4,886,295.19. (I R. 47, 64-66.) Thus as of May 28, 1942, taxpayer had made payments of interest in its taxable years 1940, 1941, and 1942 in the total amount of $260,119.59 and payments on principal in the total amount of $503,913.02. (I R. 47.)

On June 29, 1942, just prior to the close of its fiscal year, the taxpayer entered into an agreement with Securities. (Pet. Ex. 9, I R. 436-453.) The agreement referred to the fact that under the Transitory Provision the rate of interest on the indebtedness was limited to one percent and that the moratorium provisions could be waived. It recited the payments which had been made in the preceding years as interest and as reductions of principal, and stated (I R. 450-451):

> SIXTH: That it is to the interest of the Central Cuba Sugar Company in connection with the computation of its net income shown

in the "Corporation Income and Excess-Profits Tax Returns" filed with the "Collector of Internal Revenues" of the United States for the Second District of the State of New York, that the payment amounting to the sum of seven hundred and sixty-four thousand thirty-two dollars and fifty-eight cents ($764,032.58) referred to in the preceding clause be applied as payments of accrued interest at the contractual rate, and therefore, that they be considered as a deduction when computing the net income subject to tax, and the Securities and Real Estates Company of Cuba having agreed that the sums by it received be credited to the account of interest, the following is agreed upon: * * *

This agreement then purported retroactively to reallocate the prior payments which had been made in reduction of principal as though they had constituted interest payments as follows (I R. 48, 451):

	1940	1941	1942
Interest previously accrued and paid..	$ 87,016.29	$ 87,016.29	$ 86,086.98
Amounts which were previously applied to reduction of principal to be reallocated as interest	92,644.44	160,000.00	251,268.98
Total interest claimed as having accrued	$179,660.73	$247,016.29	$337,355.96

The agreement further provided that the waiver of the moratorium provisions (I R. 452) "shall only be applied to the periods of the fiscal years of the Central Cuba Sugar Company, comprised between the first day of July, 1939, and the 30th day of June, 1942", and that the collection of all other interest not paid during that period of time "shall be undemandable and may be waived" by Securities.

Notwithstanding the amount of interest which it had actually accrued on its books and in its tax returns for the fiscal years ended June 30, 1940, and 1941, the taxpayer, in its 1942 return, claimed a net operating loss deduction of $857,488.39 carried forward from the years 1940 and 1941, resulting, in part, from an asserted increase in the amounts deductible as interest for those years in accordance with the attempted reallocation described above. It also deducted, in its 1942 return, the amount of $337,355.56 as interest on the indebtedness to Securities, rather than the amount accruing under the Cuban moratorium provisions. (Pet. Ex. 3, I R. 70-91.)

The Tax Court held that during those years the taxpayer was not entitled to accrue interest on this indebtedness in excess of the rate of interest effective under the moratorium provisions, namely, one percent per year. (I R. 52-56.)[2] The Court of

[2] The Commissioner had also determined that the interest to be accrued for the fiscal year ended June 30, 1940, was

Appeals affirmed the Tax Court's decision on this issue. (II R. 12.)

2. The taxpayer corporation, which was organized under the laws of New York, was engaged in the business of growing sugar cane, and of producing and selling sugar in Cuba. It reported its income on the accrual basis for fiscal periods ending on June 30. The nature of the sugar production business is such that July 1, to January 1, is the period in which most of the year's expenses are incurred and in which there is but little income from sugar sales, that being the time during which the crop is cultivated and when preparations are made for the grinding season. The period from January 1, to June 30, is when most of the sugar sales are made and when the year's income is realized, the grinding season not commencing until the middle of January. (I R. 476-477, 492-493, 515-516, Pet. Ex. 4.)[3]

On November 14, 1942, the taxpayer transferred all its assets to a successor company of the same name, organized under the laws of Cuba, the business being continued by the successor. As con-

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only $6,198.40. The Tax Court did not sustain the determination in that respect, holding that $87,016.29 was to be accrued for that period. (I R. 55-56.) The Commissioner did not assert any error with respect to that in the Court of Appeals.

[3] Some of the exhibits were not printed but, by order of the Court of Appeals (II R. 5-6) constituted part of the record on review.

sideration for the transfer, the successor assumed all of the taxpayer's obligations and issued to the taxpayer all its common and preferred stock. The taxpayer then transferred this stock to its stockholders in exchange for its own stock, so that the former stockholders of the taxpayer became the stockholders of the successor company. These transfers, which constituted a reorganization within the terms of Code Section 112 (g), were made after a ruling by the Commissioner to the effect that a proposed transaction of this kind would not be one having as its principal purposes the avoidance of federal income taxes within the meaning of Section 112 (i) of the Internal Revenue Code. (I R. 50-51.) This ruling, dated July 17, 1942, was in response to an inquiry made by the taxpayer on June 20, 1942. (Pet. Ex. 4.)

From the beginning of its fiscal year, July 1, 1942, until November 14, 1942, when the business and business assets were transferred to the successor corporation, the taxpayer accrued certain expenses in the amount of $311,182.00. Its income in that period was $52,531.37, none of which was derived from sales of sugar produced during the 1942 season. The Commissioner, acting under Code Section 45, determined that $300,000 of these expenses should be allocated to the successor corporation in order clearly to reflect the taxpayer's income. (I R. 50, 52, 517-518.)

The Tax Court, in rejecting the Commissioner's allocation of the expenses, did so solely on the ground that there were sound business reasons for the transfer, and that the taxpayer was not primarily motivated by a tax saving purpose. Because of this, it reasoned that the Commissioner "should not be permitted, under the guise of section 45, to allocate certain of the expenses of the petitioner [taxpayer] to the Cuban corporation." (I R. 59.) The Court of Appeals reversed, holding that the Commissioner is empowered by Section 45 to make such an allocation of expenses when necessary to achieve a clear reflection of income and that the taxpayer's motives are immaterial where the Commissioner acts to prevent a distortion of income. (II R. 10-11.)

ARGUMENT

1. The courts below correctly held that the taxpayer could not accrue during the taxable years ended June 30, 1940, 1941, and 1942, a greater amount for interest on the indebtedness owing to Securities than was its legal obligation under the laws of Cuba. While the contract rate of interest was larger, the moratorium legislation in effect in Cuba during that period limited the taxpayer's interest obligation to one percent per year on the principal indebtedness. This was the only sum which constituted the fixed and ascertainable obligation of the taxpayer during those years, and it is the only sum which it could properly accrue as

interest. The taxpayer, under the most fundamental rules, could not accrue as a deduction any amount in excess of its lawful obligation. *United States* v. *Anderson,* 269 U.S. 422; *Spring City Co.* v. *Commissioner,* 292 U.S. 182; *Lucas* v. *American Code Co.,* 280 U.S. 445; *Continental Tie and L. Co.* v. *United States,* 286 U.S. 290; *Security Mills Co.* v. *Commissioner,* 321 U.S. 281; *Dixie Pine Co.* v. *Commissioner,* 320 U.S. 516.

So far as the events occurring within the taxable years 1940 and 1941 are concerned, there was nothing to fix the taxpayer's liability for interest at any rate other than that effective under the Cuban moratorium provisions. The agreement of June 29, 1942, which was made long after the close of these fiscal years, could not reach back to create the accrual of a liability which did not then exist. *Dixie Pine Co.* v. *Commissioner, supra,* p. 519; *United States* v. *Anderson, supra,* p. 441; *Security Mills Co.* v. *Commissioner, supra,* pp. 284-287.

The agreement of June 29, 1942, with Securities did not create a true interest obligation under which the taxpayer could accrue the sum of $337,355.56 as a deduction for the fiscal year ended June 30, 1942. As the agreement candidly stated, its only purpose was to alter the complexion of what the parties had done in the past in order to alter the tax consequences that would necessarily follow from what they had actually done. The agreement, however, brought about no change

of substance. While it attempted to place a new label on past transactions, with the prior payments of principal now parading as though they had always been payments of interest, it was only a paper reallocation within the same corporate family group. And, since the same stockholders controlled both corporations, it was a matter of indifference to them (except for the attempt to remold the tax consequences) how these prior payments were labelled.

Moreover, the agreement of June 29, 1942, was not even efficacious under Cuban law to achieve a partial renunciation of the moratorium as it related to the interest obligation on this indebtedness. Thus, Article 19 of Decree No. 663 (I R. 368-369), in providing for the manner of renouncing the benefits of the Transitory Provision, provided that a renunciation must, among other things, be "general in character," which requisite would be deemed met—

> a) If the renunciation comprises all obligations subject to the Transitory Provision, that are exactable from the debtor.
>
> b) When it applies to all benefits of the Transitory Provision with reference to certain properties of the renouncer.

It seems fairly obvious that the agreement here did not fulfill these requirements. Since it had application only to the prior years 1940-1942 (and

did not even purport to waive completely the moratorium rate of interest for those years), since it expressly did not waive the moratorium benefits for any future period, and since the agreement related only to the taxpayer's indebtedness to Securities, and not to any other indebtedness owing to creditors,[4] it must be concluded that the agreement did not fulfill the requirements of Cuban law since it did not comprise "all obligations subject to the Transitory Provision" and "all benefits of the Transitory Provision." Further, Article 21 (I R. 370-371) states that the fact that the debtor makes payments in excess of those provided for in the Transitory Provision should not bar its application "as said benefits shall be exactable at any time so long as the obligation is not totally fulfilled," except where there has been an effective renunciation under Article 19. Consequently, even under Cuban law the agreement with Securities did not alter the amount of the taxpayer's interest obligation in 1942.

2. The Court of Appeals was correct in upholding the Commisisoner's determination that a portion of the taxpayer's expenses should be allocated to its successor under Code Section 45 (Appendix, *infra*, pp. 18-19), in order to achieve a clear reflection of the taxpayer's income. (II R. 9-11.) The Tax Court, in holding to the contrary, had based its

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[4] That the taxpayer did have other interest bearing debts is manifest from its income tax returns.

ruling on the sole ground that there were sound business reasons for the transfer of the taxpayer's business assets to its successor. Because the taxpayer had not acted with a tax avoidance purpose, the Tax Court concluded that the Commissioner "should not be permitted, under the guise of section 45, to allocate certain of the expenses of the petitioner [taxpayer] to the Cuban corporation." (I R. 59.)

The Tax Court, in limiting the operative effect of Section 45 to situations where there has been an attempted evasion of tax, misconstrued the statute and the Court of Appeals properly reversed its decision. Section 45, by its own clear terms, grants the Commissioner authority to allocate income and deductions between related organizations not only when he determines that this "is necessary in order to prevent evasion of taxes" but also when he determines that such an allocation is necessary "clearly to reflect the income of any of such organizations." As the deficiency determination discloses (I R. 32), it was the latter grant of authority under which the Commissioner here aided. His action was consistent with the Treasury Regulations, which have long stated that the Commissioner's authority to make such an allocation is not limited to tax avoidance situations, but may be exercised whenever necessary to achieve a clear reflection of income. See Section 29.45-1 (c), Treasury Regulations 111 (Appendix, *infra*, p. 23).

Since the taxpayer transferred its business to a successor corporation at a time during the course of the year when it had already incurred the bulk of the year's expenses and prior to the time that the resulting income from this seasonal business would come to fruition, it is clear that a distortion of income is bound to result when the year's expenses are attributed to the taxpayer and the year's income is attributed to the successor. Because these expenses were incurred for the benefit of the successor, the Commissioner acted properly in allocating a portion of these expenses to the successor so that the taxpayer's income would be reflected clearly and so that the taxpayer would not be entitled to claim a large loss from carrying on, during a portion of the year, what was actually a profitable business for the whole year. Cf. *Standard Paving Co.* v. *Commissioner,* 190 F. 2d 330 (C.A. 10th), certiorari denied, 342 U.S. 860; *Jud Plumbing & Heating* v. *Commissioner,* 153 F. 2d 681 (C.A. 5th); *Leedy-Glover Rlty. & Ins. Co.* v. *Commissioner,* 184 F. 2d 833, 834 (C.A. 5th); *Miles-Conley Co.* v. *Commissioner,* 173 F. 2d 958, 961 (C.A. 4th).

Contrary to the taxpayer's contention (Pet. 23-25), the Tax Court did not purport to find what would result in a clear reflection of the taxpayer's income. Indeed, ignoring this aspect of Section 45, the Tax Court did not consider the matter at all. In any event, since the taxpayer offered no

evidence to demonstrate that the Commissioner had abused his discretion in allocating $300,000 of the expenses to the successor or to show that this did not result in a clear reflection of its income, familiar principles required that the Commissioner's deficiency determination be sustained. The Court of Appeals, quite properly, reversed the Tax Court for having failed to do so.

CONCLUSION

There are no conflicting decisions on either issue and no other valid reason exists why this Court should grant further review. The petition for a writ of certiorari should be denied.

Respectfully submitted,

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OCTOBER, 1952.

APPENDIX

INTERNAL REVENUE CODE:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

(a) *Expenses.*—[As amended by Section 121 (a), Revenue Act of 1942, c. 619, 56 Stat. 798]

(1) *Trade or Business Expenses.*—

(A) *In General.*—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, * * *.

* * * * * *

(b) *Interest.*—All interest paid or accrued within the taxable year on indebtedness * * *.

(26 U.S.C. 1946 ed., Sec. 23.)

SEC. 41. GENERAL RULE.

The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in

the opinion of the Commissioner does clearly reflect the income. If the taxpayer's annual accounting period is other than a fiscal year as defined in section 48 or if the taxpayer has no annual accounting period or does not keep books, the net income shall be computed on the basis of the calendar year.

(26 U.S.C. 1946 ed., Sec. 41.)

SEC. 43. PERIOD FOR WHICH DEDUCTIONS AND CREDITS TAKEN.

The deductions and credits (other than the corporation dividends paid credit provided in section 27) provided for in this chapter shall be taken for the taxable year in which "paid or accrued" or "paid or incurred," dependent upon the method of accounting upon the basis of which the net income is computed, unless in order to clearly reflect the income the deductions or credits should be taken as of a different period. * * *

(26 U.S.C. 1946 ed., Sec. 43.)

SEC. 45. ALLOCATION OF INCOME AND DEDUCTIONS.

In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Commissioner is author-

ized to distribute, apportion, or allocate gross income or deductions between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.

(26 U.S.C. 1946 ed., Sec. 45.)

Treasury Regulations 111, promulgated under the Internal Revenue Code:

Sec. 29.45-1. *Determination of the Taxable Net Income of a Controlled Taxpayer.*—(a) *Definitions.*—When used in this section—

(1) The term "*organization*" includes any organization of any kind, whether it be a sole proprietorship, a partnership, a trust, an estate, or a corporation (as each is defined or understood in the Internal Revenue Code or these regulations), irrespective of the place where organized, where operated, or where its trade or business is conducted, and regardless of whether domestic or foreign, whether exempt, whether affiliated, or whether a party to a consolidated return.

(2) The terms "*trade*" or "*business*" include any trade or business activity of any kind, regardless of whether or where organized, whether owned individually or other-

wise, and regardless of the place where carried on.

(3) The term *"controlled"* includes any kind of control, direct or indirect, whether legally enforceable, and however exercisable or exercised. It is the reality of the control which is decisive, not its form or the mode of its exercise. A presumption of control arises if income or deductions have been arbitrarily shifted.

(4) The term *"controlled taxpayer"* means any one of two or more organizations, trades, or businesses owned or controlled directly or indirectly by the same interests.

(5) The terms *"group"* and *"group of controlled taxpayers"* mean the organizations, trades, or businesses owned or controlled by the same interests.

(6) The term *"true net income"* means, in the case of a controlled taxpayer, the net income (or, as the case may be, any item or element affecting net income) which would have resulted to the controlled taxpayer, had it in the conduct of its affairs (or, as the case may be, in the particular contract, transaction, arrangement, or other act) dealt with the other member or members of the group at arm's length. It does not

mean the income, the deductions, or the item or element of either, resulting to the controlled taxpayer by reason of the particular contract, transaction, or arrangement, the controlled taxpayer, or the interests controlling it, chose to make (even though such contract, transaction, or arrangement be legally binding upon the parties thereto).

(b) *Scope and purpose.*—The purpose of section 45 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer, by determining, according to the standard of an uncontrolled taxpayer, the true net income from the property and business of a controlled taxpayer. The interests controlling a group of controlled taxpayers are assumed to have complete power to cause each controlled taxpayer so to conduct its affairs that its transactions and accounting records truly reflect the net income from the property and business of each of the controlled taxpayers. If, however, this has not been done, and the taxable net incomes are thereby understated, the statute contemplates that the Commissioner shall intervene, and, by making such distributions, apportionments, or allocations as he may deem necessary of gross income or deductions, or of any item or ele-

ment affecting net income, between or among the controlled taxpayers constituting the group, shall determine the true net income of each controlled taxpayer. The standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer.

Section 45 and this section apply to the case of any controlled taxpayer, whether such taxpayer makes a separate or a consolidated return. If a controlled taxpayer makes a separate return, the determination is of its true separate net income. If a controlled taxpayer is a party to a consolidated return, the true consolidated net income of the affiliated group and the true separate net income of the controlled taxpayer are determined consistently with the principles of a consolidated return.

Section 45 grants no right to a controlled taxpayer to apply its provisions at will, nor does it grant any right to compel the Commissioner to apply such provisions. It is not intended (except in the case of the computation of consolidated net income under a consolidated return) to effect in any case such a distribution, apportionment, or allocation of gross income, deductions, or

any item of either as would produce a result equivalent to a computation of consolidated net income under section 141.

(c) *Application.*—Transactions between one controlled taxpayer and another will be subjected to special scrutiny to ascertain whether the common control is being used to reduce, avoid, or escape taxes. In determining the true net income of a controlled taxpayer, the Commissioner is not restricted to the case of improper accounting, to the case of a fraudulent, colorable, or sham transaction, or to the case of a device designed to reduce or avoid tax by shifting or distorting income or deductions. The authority to determine true net income extends to any case in which either by inadvertence or design the taxable net income, in whole or in part, of a controlled taxpayer, is other than it would have been had the taxpayer in the conduct of his affairs been an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer.

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REPLY BRIEF

In The

Supreme Court of the United States

October Term, 1952

No. 332

Central Cuba Sugar Company, *Petitioner*

vs.

Commissioner of Internal Revenue, *Respondent*

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Second Circuit

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REPLY TO RESPONDENT'S OPPOSITION

The respondent takes the position on the "interest issue" that the *liability of petitioner* to pay interest accrued at contract rates for the use of borrowed money is limited to the amount thereof that may be *demanded* by the creditor under the Transitory Provisions of the Moratorium Laws of Cuba; and upon such hypothesis, he argues that the amount of contract interest (for the use of borrowed money) *actually paid* by petitioner—pursuant to the agreement of June 29th, 1942—is not allowable as

a deduction within the meaning of Section 23(b) of the Code, as construed by the Court in the case of *Deputy* vs. *Du Pont,* 308 U. S. 488, and *Commissioner* vs. *Park,* 113 Fed. (2d) 352.

The respondent (analogous to his proposal herein) has heretofore sought to apply to the provisions of Section 23(b) of the Code a narrow construction by arguing that the word "interest" as used in the statute "must be restricted to payments *which one has contracted* to make for the *use of borrowed money*". (See *Commissioner* vs. *Park,* 113 Fed. (2d) 352). However, with respect to such a narrow construction of the meaning of the word "interest" as used in the Statute, the Court said:

> "• • • This is one meaning of the word but not its sole meaning. Mr. Justice Douglas in Deputy v. DuPont, supra, (308 U. S. 488, 60 S. Ct. 368, 84 L. Ed. 416), gave the term a wider meaning when he stated that: 'In the business world "interest on indebtedness" means compensation for the use or forbearance of money.' Interest, according to this authoritative definition, may, therefore be not only the price paid for the use of borrowed money but also that paid a creditor for his forbearing to demand the payment of money legally due. See also Klein, Federal Income Taxation, Pr. 16:4. The present case falls squarely within the latter category, for the payments were made to the wife so long as she forbore to make demand upon the taxpayer for the payment of the note."

In the *Park case, supra,* the question was whether or not there existed a *bona fide* indebtedness to support the *accrual of interest.* The Court found there was such an indebtedness; but that it was not with respect to *borrowed money.* In that case there was a binding and *enforceable* obligation of the taxpayer to *pay a sum of money;* and that during the *executory* period of the promise, the holder of the note would forbear demand for its payment in consideration of the payment of *interest* on the amount promised at a future date. There was,

however, a legal indebtedness to support the *accrual of interest.*

There was, of course, no *use of borrowed money* as the basis of an indebtedness; but the Court said, in effect:

> Interest (according to the definition thereof given in the case of *Deputy* vs. *Du Pont,* 308 U. S. 488) may be—not only the price paid for the use of borrowed money—but also (in the alternative) the price paid a creditor for his forbearing to demand the payment of money *legally promised at some future date.*

The *indebtedness* in this proceeding is based upon the *use of borrowed money* in the trade or business of the taxpayer. There was an *unconditional* obligation of the taxpayer to repay the loan *at some future date;* and when the date of payment occurs by the lapse of time, the indebtedness agreement *is enforceable.*

The Courts below find that the taxpayer used the *borrowed money in its trade or business;* but they undertake to say that the right of the creditor to demand the payment of interest accrued at contract rates is *unenforceable.* That is, the Courts below accept the argument of respondent that *forbearance* of the creditor—pursuant to the Moratorium Laws of Cuba—changes the meaning of the term "interest" of Section 23(b) of the Code, as defined by *Deputy* vs. *Du Pont, supra*; and with respect to the obligation of the debtor, who is using the money of the creditor in his trade or business, the amount of "interest" deductible is limited to the amount of interest that the creditor may forbear under the Moratorium Laws of Cuba. The Courts below put to one side the *accrual of interest* at reasonable rate for the use of borrowed money, as provided by Section 23(b) of the Code.

It is not the public policy of the United States to gather its revenue by *limiting the rate of interest* that a taxpayer may agree to pay for the use of borrowed money

to *1% and/or 5% of the principal of the debt therefor;* and, pursuant to the public policy of the United States as expressed in Section 23(b) of the Code, the Moratorium Laws of Cuba (that deal only with forbearance) should not be applied as a part of the public policy of the United States. (See *Dorzback* vs. *Collison,* 195 Fed. (2d) 69).

There is a grave and serious conflict between the decisions of the Courts below in this proceeding and the cases of *Deputy* vs. *Du Pont; Commissioner* vs. *Park;* and *Dorzback* vs. *Collison, supra.*

The opposition of respondent magnifies such conflict; and it is apparent that the conflict will be highly *prejudicial* to this petitioner (contrary to the public policy of the United States) unless it is reconciled and/or removed by an authoritative decision of this Honorable Court—pursuant to the command of the *public policy of the United States.* (See *Commissioner* vs. *Heininger,* 320 U. S. 467, and *Lilly* vs. *Commissioner,* ..... U. S. ..... (96 L. Ed. Advance Sheet 385)).

The public policy of the United States to be fair to all taxpayers is traditional; and the least infraction of such policy, even though of an isolated character in the case of a taxpayer transacting its trade or business outside the United States, the uniformity required in the administration of the laws of the United States has been violated with prejudicial effects on the good faith conduct of officials and the integrity of the United States.

Reliance upon color of the Moratorium Laws of a foreign country as a guide for the administration of the laws of the United States is not permissible under the provisions of Section 43, Title 8, USCA; and, in a case where the color of a foreign law is made inapplicable—as provided therein—it is against the public policy of the United States for an official and/or its Courts to rely

upon a foreign statute that is made *inapplicable* to the question at issue, within the meaning of Section 23(b) of the Code. This proceeding means more to the integrity of the United States than the mere question of alleged tax liability of petitioner that is the basis of the controversy.

Respectfully,

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